

## Sonae SGPS Presenting A Great Entry Point With A Catalyst: The IPO Of Its Food Retail Business

Aug. 16, 2018 2:42 PM ET  
by: European Deep Value Research

### Summary

- Sonae SGPS continues to increase shareholder value.
- Current market correction presents an opportunity.
- There are catalysts for value realization.

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### Investment Thesis

Sonae SGPS (OTC:SGPMY) continues to make the right moves towards value creation. Aside from a good earnings report, the company has been making good capital allocation decisions. Even so, the stock is down 16% this year. But there is a relevant near-term catalyst that could bring the stock closer to fair value: the IPO of its food retail business.

### Market Doubts

Sonae SGPS has fallen about 16% YTD despite having presented a good Q1 earnings report. Reasons for this disconnection could be related to:

- Recently announced leadership change from Co-CEOs Paulo Azevedo/Ângelo Paupério to Cláudia Azevedo (currently at Sonae IM).
- Sector uncertainty considering new competitors entering the market: Mercadona (Spanish retailer) and Amazon (NASDAQ:AMZN).
- Low market visibility of its fully consolidated businesses.

## Good Capital Allocation Decisions

Sonae continues to add value to the business with its capital allocation decisions.

Recently, it has concluded the merger of its Sports Retail Business (Sportzone) with the Iberia unit of JD Sports, creating a market leader with positive EBITDA.

Also, Sonae IM, the tech investment arm of Sonae, managed by future CEO Cláudia Azevedo, has revealed that it will receive from one of its investments, Fund FCR Armilar Venture Partners II, **a capital distribution amounting to 57,821,078.94 EUR** (before taxes). Aside from that, it was also made public that Outsystems, a Portuguese tech company that is 25% owned by the same fund, got a private capital injection that **valued the company for more than 1.000 mln EUR**. This fact will considerably increase the value of the Fund.

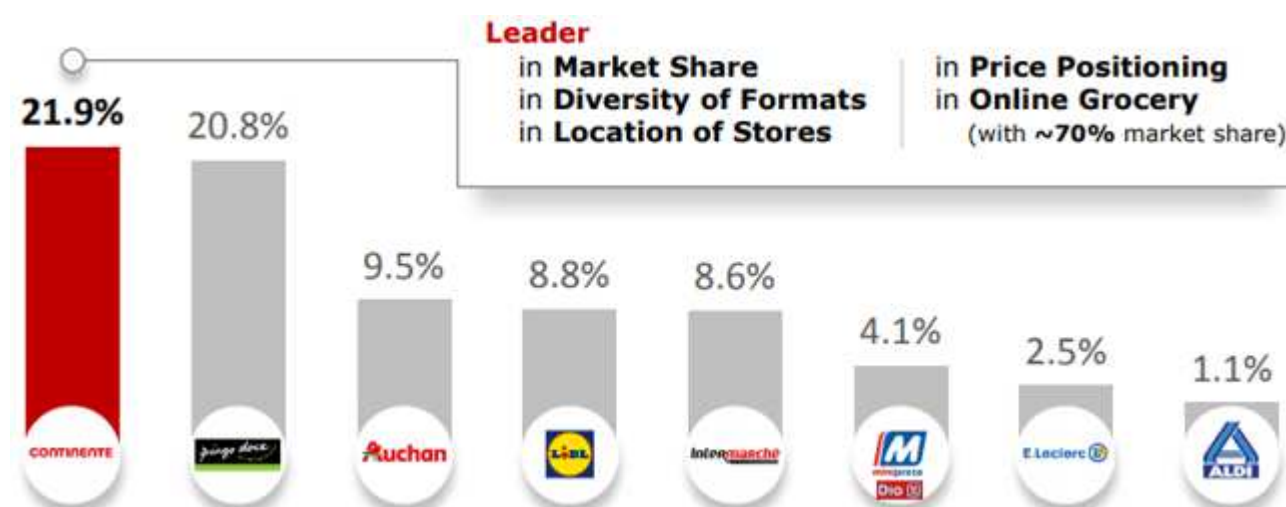
Sonae owns 45.65% of the Fund Armilar Venture Partners II. The company bought this and other positions in other Armilar funds back in December 2016 for 31.7 mln euros, from the bank Novo Banco.

## A New Catalyst: The IPO Of The Food Retail Business

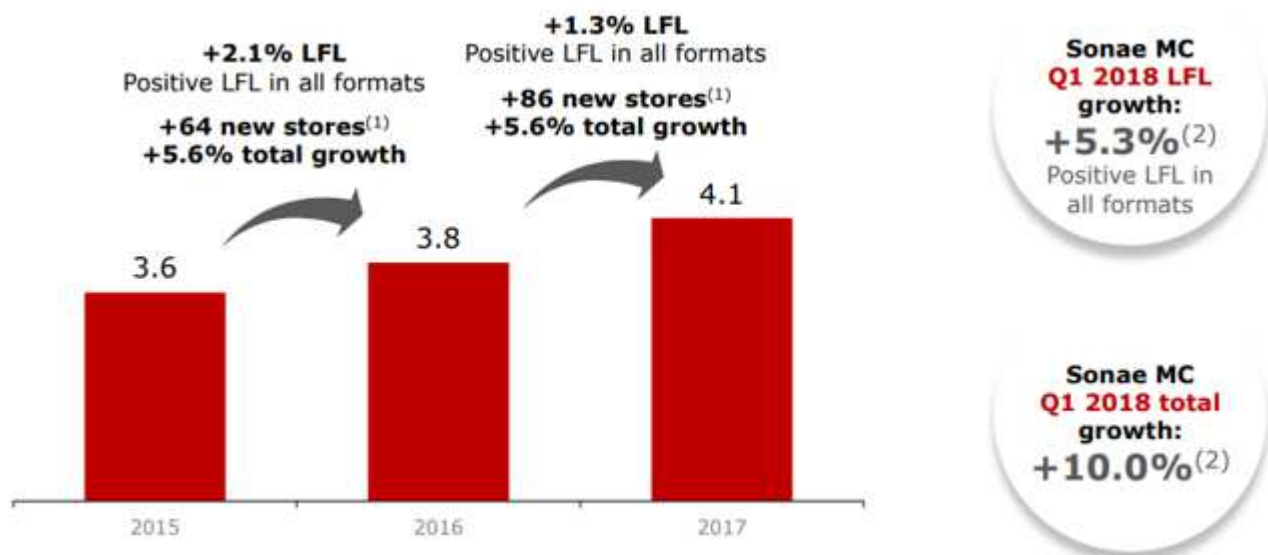
Sonae has announced it is considering the listing of its food retail business (Sonae MC + Retail Properties), the biggest and most profitable part of its fully consolidated businesses. The last update they made on this process was in May.

Sonae MC has compelling fundamental characteristics that distinguish it within its sector.

Continente (Sonae's Food Retail Stores) is a clear market leader in Portugal:



It is growing strongly, both with new store openings and on a same-store-sales basis:



New investments and competition have been hurting margins in the last couple of years. But they are stabilizing:

Profitability (€m)			
	2015	2016	2017
EBITDAR	370	384	397
Margin (% of turnover)	10.2%	10.0%	9.8%
Rents	62	84	94
EBITDA <sup>(1)</sup>	308	300	303
Margin (% of turnover)	8.5%	7.8%	7.5%

**Sonae MC Q1 2018 margin expansion: +10bps YoY<sup>(2)</sup>**

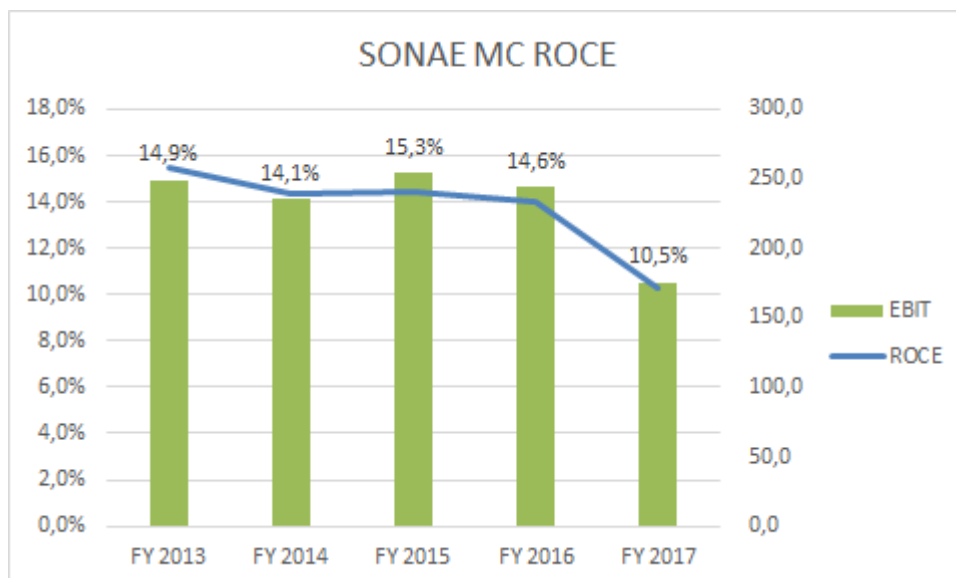
Still, at current levels, margins have to be considered best-in-class:

	EBITDA Margin
Carrefour (OTCPK:CRRFY)	4.6%
Tesco (OTCPK:TSCDY)	5.1%
Ahold (OTCQX:ADRY)	6.8%
Jerónimo Martins (OTCPK:JRONY)	5.7%
DIA (OTCPK:DIDAF)	6.6%
Mediana	5.7%
Sonae MC	7.5%

Source: Capital IQ

Also, despite a compression in 2017, its returns are elevated (ROCE = EBIT/Invested

Capital):



The IPO is an opportunity to emphasize the value of this business. If Sonae is able to get this done, it will be a powerful catalyst for the stock.

## How Is The Market Valuing Sonae MC

Sonae SGPS is composed of several businesses ranging from food to specialized retail, from financial services to technology.



Sonae has a current market cap of 1.770 mln EUR, net financial debt of 1.267 mln EUR and an EV of about 3.037 mln EUR.

1. Sonae Sierra (the Real Estate Developer, Owner and Manager) and NOS participation (Telco) are equity consolidated. They have a market value that is easily determined.

Business	Market Value	Sonae SGPS Equity Interest %	Sonae SGPS Equity Interest Value

<b>Sonae Sierra</b>	1.412,6	50,0%*	706,3
<b>NOS</b>	2.544,0	23,4%	595,3
<b>Total</b>			<b>1.301,6</b>

\* Sonae has recently increased its position in Sonae Sierra to 70%. The net effect of this fact doesn't change the conclusions of this exercise.

Considering Sonae SGPS has 2.000 mln shares outstanding, these 2 positions are worth 0.65 EUR per share. Sonae SGPS is currently trading at 0.94 EUR or 1.770 mln EUR.

(Actually, the case can be made that NOS is significantly undervalued, trading at an EV/EBITDA multiple of 6.35).

2. Smaller fully consolidated businesses include Worten, Sonae Sports and Fashion (S&F), Financial Services (FS) and Sonae Investment Management (IM):

- Worten, S&F and FS have made 1.592 mln EUR in sales in 2017 and 54 mln EUR of EBITDA. These are not terrific businesses. But if we valued them at a conservative 6x EV/EBITDA multiple, taking into account that the EBITDA is still depressed, we obtain a reasonable valuation of 324 mln EUR.
- Sonae IM's consolidated businesses are generating 126 mln in sales and 4 mln EBITDA. But its IM's investments are producing good results already, as presented before. It can, at least, be valued for the capital distribution it will receive: 57.8 mln EUR.

3. In total these 2 groups of businesses are worth 1.683 mln EUR. This means that Sonae MC is being valued at an EV of  $3.037 - 1.683 = 1.354$  mln EUR. Considering that this business (Sonae MC and Retail Properties) is generating 299 mln EUR EBITDA (FY 2017), they are being valued at 4.53x EBITDA. Extremely cheap, taking into account that competitors have lower margins and returns and trade at 7x-8x EBITDA.

	EV/EBITDA
Carrefour	5.6
Tesco	9.7

Ahold	6.9
Jerónimo Martins	8.0
DIA	7.0
Mediana	7.0
Sonae MC	4.5

Source: Capital IQ

## Risks

- Mercadona's (Spain's No. 1 food retail operator). Mercadona is a solid operation and can use its efficient logistics system to operate also in Portugal.

Other strong competitors like Lidl and Aldi have also entered the Portuguese market and couldn't take market share from Continente.

- Amazon's entrance into the Portuguese market could present long-term challenges to Sonae's dominance.

Sonae has currently a 70% online market share. It won't always be like this but it will maintain the biggest, most efficient logistics system in Portugal and that is a great advantage.

- Consumption slowdown.

Expectations from the Bank of Portugal are for a continuation of economic expansion inline with Eurozone estimates.

		2017	2018 (p)	2019 (p)	2020 (p)
<b>Gross Domestic Product</b>	 Portugal	2.7	2.3	1.9	1.7
	 Euro area	2.5	2.1	1.9	1.7
<b>Private consumption</b>	 Portugal	2.3	2.2	1.9	1.7
	 Euro area	1.7	1.6	1.7	1.5

Source: Bank of Portugal

- Country risk: Portugal - the risk of a debt meltdown like 2011/2012.

Portugal is returning to investment grade status. Although much is left to do to reduce public debt (the main problem), it is on a solid path to do that.

## **Conclusion**

Sonae SGPS's stock correction this year has given investors a new excellent entry point. The company is presenting good results, it is taking adequate capital allocation decisions, and it has a valuable pending catalyst.

The IPO of its food retail business will highlight the quality of this business and help reduce the discount to a reasonably fair value.